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MEMORANDUM FOR: DCI STA

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- - the Wall Street Journal article on the same subject

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WALL STREET JOURNAL 4 Oct. 1984

Ailing Economy

Israel's Foreign Debt And Soaring Inflation Peril Nation's Security

Steps to Deal With Them Risk More Polarization; Peres Will Meet Reagan

Disadvantage of Democracy

By Gary Putka
Staff Reporter of The Wall Street Journal

JERUSALEM—For years Israeli governments have kept this nation's economic disease from having serious political repercussions. This may no longer be possible.

The new government of Prime Minister Shimon Peres has made the economy its first priority, ahead of withdrawing troops from Lebanon or trying to improve relations with Egypt. It has already initiated an austerity plan. And next week, less than four weeks after taking office, Mr. Peres travels to Washington to seek American help.

But many who have studied the debt-laden and hyperinflationary economy say that that won't be enough. Unless stronger steps are taken, some analysts predict, Israel in a year or two will be unable to pay interest on its foreign debts.

Although more than half of Israel's $24 billion debt is in relatively friendly hands—the U.S. government and holders of Israel Bonds—a loan default would require international negotiations. And these would doubtless lead to belt-tightening measures so intolerable to many Israelis—who are used to a steadily rising standard of living—as to threaten the stability of Washington's closest ally in the Middle East.

'A Very Rough Patch'

In fact, stability could be threatened by any actions strong enough to right the economy and avert a foreign-debt crisis. "They're headed for a very rough internal patch," says Richard Viets, a former U.S. envoy to Israel who just completed a stint as ambassador to Jordan. "Very few people realize the kind of Draconian measures that will be needed."

Even under the current austerity plan, private forecasters predict record unemployment and inflation. In that event, an already polarized society could be further torn apart. Hard times in the Israeli-occupied territories, for example, could fan resentment in an Arab population whose living standard is already far below the Israeli norm.

Throughout the country "there will be unemployment, social unrest and everything that attends austerity," says Amnon Rubinstein, Israel's new minister of communications. "There will probably be some violence. We hope it can be avoided."

Until now at least, the government has seemed unable or unwilling to control spending. A year ago Jerusalem announced spending cuts of 5% to 6%, cuts that many in the government concede were never effected because strict controls weren't imposed. "I believe we are living in the middle of a terrible fiction," says Daniel Doron, who runs the Center for Social and Economic Progress in Tel Aviv. "There is no real budget. A lot of the process is out of control. The teachers strike one day, and suddenly an exception is made. With inflation this high, you're navigating without signals."

Shekel Declines

August's 16.5% increase in prices compounds to an annual inflation rate of more than 500%. The shekel has depreciated 75% against the U.S. dollar this year. Unemployment is approaching 6%.

The economic troubles may harm Israel's military preparedness. The new austerity package includes cuts of about $350 million in the nation's $4.3 billion defense budget, and further cuts could come next year. Such reductions might narrow Israel's military edge over its Arab adversaries.

Until yesterday, Israeli officials had said that Mr. Peres would seek emergency financial aid from President Reagan next week—and the U.S. already subsidizes Israel to the tune of $2.6 billion in grants earmarked for that country in 1985. Mr. Peres said yesterday, however, that he wouldn't seek "beggar's assistance." Aides to the prime minister said he would instead seek long-range restructuring of the U.S. aid program. Mr. Peres declared, "Healing the economy I see as a purely Israeli mission."

Borrowing and GNP

Israel faces economic dangers on several fronts. Its foreign borrowings are growing at the rate of about $2 billion a year. They now are as large as its gross national product. With debt service eating up 40% of the national budget, worries are growing that Israel won't be able to bear the burden much longer. Israeli government officials say that foreign banks have been unwilling to extend new credit to Israel for the last half-year, but they have negotiated rollovers and Israel continues to borrow from other sources.

Meanwhile, inflation and the decline of the shekel have prompted Israelis to frantically buy dollars to protect their purchasing power, thus draining foreign-currency reserves. Central-bank holdings of foreign cash, a benchmark of a country's ability to honor foreign liabilities, have dropped well over 50% this year, to $2.1 billion. In an effort to halt the decline, the government has just banned, for six months, the import of a variety of consumer goods ranging from chocolate to various electrical appliances.

"We are in a situation similar to Mexico's two years before its crisis," says Assaf Razin, an economist at Tel Aviv University. "Our foreign borrowings are growing, and

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Ailing Economy: Foreign-Debt Burden and Inflation Imperil Israel's Security; Remedies Risk Polarization

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they could increase to dangerous levels."

Stanley Fischer, a professor at the Massachusetts Institute of Technology who has studied the Israeli economy for the U.S. State Department, says that the "trouble will come when they can't renew loans or borrow from commercial sources." Foreign banks are currently rolling over, on an annual basis, between $4 billion and $5 billion in short-term loans.

Yitzhak Modai, the new finance minister has announced the new austerity plan. It includes $1 billion in projected annual budget cuts, increases in taxes and in charges for public services and reductions in food subsidies. The plan looks tough, but doubts remain about whether it is enough and whether the government can make the budget cuts stick.

"If budget cuts were [to be effective], they would [have to] be on the order of $1.5 billion to $2 billion," says Mr. Razin of Tel Aviv University. "With smaller cuts, the present dangerous trend will continue."

Mr. Fischer of M.I.T. says that the budget cut needs to be at least as big as Israel's current-account deficit to do any good, because this figure represents the amount Israel needs to borrow to keep its economy afloat. Last year the deficit in Israel's current account, the balance sheet reflecting the payments for goods and services and the dividends and interest on investments, was $2.2 billion.

"I agree with those who say this [budget cut] isn't enough," Finance Minister Modai says, "but this is the middle of a budget year and lots of advance commitments have been made. We will need to cut even deeper next year."

Inflation is spiraling higher. Mr. Modai says that the austerity plan will mean September-October price increases of more than 20% in each of the two months, which, compounded, mean an annual inflation rate of about 900%. Price increases this astronomical could threaten the social order. Israel has had riots before over much smaller price increases, and food hoarding and panicky buying of the dollar have become regular events in the last year.

Furthermore, austerity is coming to an Israel that is more deeply divided than at any other time in its history. In the recent election, the nation split its votes equally between the rightist-nationalists who have ruled Israel for the last seven years and the socialists led by Mr. Peres's Labor Party. Polls show that half the country favors giving up occupied territory for peace, the other half doesn't.

Likely to be squeezed hardest by the belt-tightening are the poor, and the poor in Israel have voted strongly against Labor and Mr. Peres in the past. They have identified with activist movements that favor Israeli settlement on the West Bank of the Jordan River.

"The types of measures that are coming will bite first and foremost at the very class of people that have supported the rightist and religious [parties]," says Mr. Viets, the U.S. diplomat. "They know how to *act*. There will be unemployment on a major scale. And as subsidies are cut back, there will be a surge of prices. That spells for me social upheaval."

Some Israeli officials say that Israel is in a better position than other debtor states because it owes most of its debt to lenders who are friendlier than commercial banks. Of the $24 billion foreign debt, the U.S. government holds $10 billion. In addition, some $4 billion is owed to buyers of Israel Bonds, mostly the American Jewish community.

Gad Yaacobi, Israel's economics minister, says that asking for forgiveness of some of the U.S. debt has been discussed in Israeli government circles. "I am not for it," says Mr. Yaacobi. "It would hurt the financial credibility of the state." Renegotiating the U.S. debt and asking Israel Bond buyers for a "moratorium" on interest payments are a "moratorium" on interest payments are potential emergency valves that could prevent a Latin American type of debt crisis.

But Israel also has some disadvantages that some other debtor states don't face. It is a democracy, meaning that its government cannot impose austerity measures without facing retribution at the polls. Nearly everyone in the country agrees that that is one reason the problems haven't been dealt with earlier.

Although Mr. Peres's new government of socialist-rightist "national unity" may be less vulnerable to a voter backlash, it is cumbersome and may be burdened with considerable internal bickering. Some of the 25 cabinet ministers have already criticized the economic program and opposed cuts from their budgets.

"Each side will try to shift responsibility for the painful parts of the program to the other side," says Emmanuel Gutmann, a political-science professor at Hebrew University in Jerusalem. Mr. Gutmann thinks the government will probably be able to execute its economic plans but may face gridlock on other issues, such as the settlements in the occupied territories.

The Israeli public has high economic expectations. With a per capita income of $6,000, or half the U.S. average, most Israelis don't lead what Americans would call a lavish life style. But they have experienced an almost unbroken rise in their standard of living in the last 10 years, including an 8% rise in real income in the last two years. One in eight took a foreign vacation this past summer, and for most of this year the sales of cars, television sets and other luxury goods were soaring despite climbing prices.

"The economy? It's terrible," says Shlomo Etzion, as he steers his brand-new Mercedes-Benz taxi past a truck on the Tel Aviv-Jerusalem highway. "But my business is fine. I went to Luxembourg for the car—$15,000. Nice, no?" Yaacov Orenstein, a recently retired water-company worker in Beersheva, says that he knows the economic situation in Israel is bad but that he hasn't changed his plans to build a new house for his retirement.

U.S. officials have said they want to see evidence that Israel is serious about belt-tightening before they say yes to any request for increased aid. But in the end, few believe that the U.S. will balk at a bailout, if necessary, for its ally.

That the belt-tightening will weaken Israel is a real possibility. Speaking of the defense-budget cuts contained in the new austerity package, Israeli Defense Minister Yitzhak Rabin says: "No doubt the cuts will reduce Israel's defense capabilities. By how much, I'm not in a position to say."

In the long run says Mark Heller of the Jaffee Center for Strategic Studies in Tel Aviv, Israel may have to forgo high-technology projects such as the development of its new Lavi jet fighter, which is costing between $200 million and $300 million a year. But the Lavi is a pet project of former Defense Minister Moshe Arens and the powerful Israeli defense industry. Fights could develop over this and almost every other government expenditure in Israel in the next two years. In the past, the fights have been resolved with few reductions.

"I admit that our past failures don't encourage you to believe there will be a success this time," says Mr. Modai. "I give you just one argument: This time we don't have any choice."

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